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In the Supreme Court of the United States

OCTOBER TERM, 1948

No. 151

NATIONAL CARBIDE CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

No. 152

AIR REDUCTION SALES COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

No. 153

PURE CARBONIC, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. A. 5-36)[1] are reported at 8 T.C. 594.

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[1] The printed record filed in this Court consists of three parts which, although fastened together as a single volume, are separately paged. The first part will be referred to herein as

The opinion of the Circuit Court of Appeals (R. C. 1-9) is reported at 167 F. 2d 304.

JURISDICTION

The judgments of the Circuit Court of Appeals (R. C. 10, 12, 14) were entered on March 31, 1948. A petition for rehearing (R. C. 16-21) dated April 14, 1948, was denied on April 19, 1948 (R. C. 22, 24). A petition for writs of certiorari was filed on July 14, 1948.

The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925. Effective September 1, 1948, this will be Title 28, United States Code, Section 1254.

QUESTION PRESENTED

The taxpayers are regularly organized corporations, owning valuable assets and employing officers and employees. They manufacture products which they sell to the public at a profit. All of their stock is owned by a parent corporation, to which they have agreed to pay over all except a most nominal part of their earnings.

The question is whether the Circuit Court of Appeals was correct in holding that the taxpayers were taxable on all the income which they earned, and in reversing the Tax Court which had held

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"R.A." and consists of the Appendix to the Government's brief in the Circuit Court of Appeals. The second part will be referred to herein as "R.B." and consists of the Appendix to the taxpayers' brief in the Circuit Court of Appeals. The third part, referred to as "R.C." consists of the proceedings in the Circuit Court of Appeals.

that they were not taxable on the portion of their income which they paid over to the parent corporation pursuant to agreement.

STATUTE AND REGULATIONS INVOLVED

The applicable provisions of the statute and regulations involved are set forth in the Appendix, *infra*, pp. 18-20.

STATEMENT

These proceedings involve asserted deficiencies in income and declared value excess-profits taxes for the calendar year 1938. (R. A. 5-7.) Although the Tax Court's findings of fact are extensive (R. A. 7-28), the pertinent facts may be summarized as follows:

Each of the taxpayers, possessing only a nominal capitalization, is a wholly owned subsidiary of Airco Reduction Company. (R. A. 7, 11.) They are engaged in the manufacture and sale of chemicals and chemical gases. (R. A. 7-8.)

The taxpayers own valuable assets which they employ in their business. Some of these were acquired as a result of the transfer of physical property to them from the parent company, directly or at its direction. The taxpayers showed a book indebtedness to the parent for the value of this property. Further assets were acquired as a result of direct purchases made by the taxpayers out of their earnings and out of funds advanced by the parent. They also showed a book indebtedness to the parent for the value of these assets. (R. A. 20-21.) Certain gas cylinders, however, were owned

by the parent corporation and were allocated to the various subsidiary companies as required by them. (R. A. 21.) The subsidiaries, apparently, were not charged any rental for the use of these cylinders.

During the taxable year there were in existence similar contracts between each of the taxpayers and the parent company. Pursuant to each agreement the parent purported to employ the subsidiary "as its agent" to manage and operate the plant, and to market and sell the output, the subsidiary agreeing to pay to the parent "all profits accruing to it from the operation of its entire business", except that the subsidiary was entitled to retain an amount equal to 6 percent on its outstanding capital stock (nominal in amount), which sum it agreed to accept as its compensation. (R. A. 12-13, 14-16, 17-19.) The accounts between the parent and the subsidiary were kept strictly in accordance with these agreements. (R. A. 28, 32.)

Because of its stock ownership, and by means of common directors and officers, the parent company exercised complete control over the business functions, policies, and funds of the taxpayers. It was also able to achieve a close integration of the operations and facilities of the taxpayers. (R. A. 30-32.)

In their returns for the taxable year, each of the taxpayers deducted the amount paid or credited to the parent pursuant to the agreements, thereby

reporting as income only the nominal amounts which they purported to retain as compensation for their services. The Commissioner determined deficiencies after concluding that the subsidiaries were taxable on all their income, undiminished by the amounts paid or credited to the parent. In so doing, however, he permitted a deduction for certain expenses which had been incurred by the parent company, but which the Commissioner allocated to the taxpayers under Section 45 of the Revenue Act of 1938. (R. A. 5-7.) The Tax Court refused to sustain the Commissioner's deficiency determinations, holding that the taxpayers were operated as incorporated branches or divisions and as corporate agents of the parent and that the income was owned by the parent and taxable to it. (R. 28-36.)

The Circuit Court of Appeals reversed the Tax Court. It held that since the taxpayers were separate corporations engaged in a business, they were taxable on their own earnings despite the fact that they were wholly owned subsidiaries, and despite the fact that they had attempted to deflect their earnings to the parent by means of an "agency" device. (R. C. 1-9.)

ARGUMENT

I. The decision below is correct in holding that the taxpayers, which are wholly owned subsidiaries of a common parent company, are taxable on the separate incomes which they earned. Each taxpayer is a distinct, regularly organized corporation

carrying on a business. Each, as a corporation, in the conduct of its business, owns and controls assets of considerable magnitude. Thus, $16,000,000 worth of assets is owned by Air Reduction Sales Company, $2,000,000 by Pure Carbonic, Inc., and $1,600,000 by National Carbide Corporation. (Resp. Ex. A, B, and C.)[2] They each have their own officers and employees and, through a combination of their assets and the services of their employees, each corporation manufactures its own products which are sold to the public at a profit. Air Reduction Sales Company's net sales exceeded $15,000,000, and it enjoyed a net income which exceeded $3,000,000; Pure Carbonic, Inc., had net sales in excess of $4,000,000, with a net income in excess of $150,000; National Carbide Corporation's net sales were in excess of $3,000,000, and its net income exceeded $800,000. (R. A. 9-10; Resp. Ex. A, B, and C.) The Tax Court ruled that the taxable income of each taxpayer was equal to 6 percent of its capital stock, which was only nominal in amount, this being the portion of the earnings which the taxpayers were entitled to retain under contracts in which they had agreed to pay the balance of their profits to the parent company.

The Circuit Court of Appeals, reversing the Tax Court, correctly held that the taxpayer corpora-

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[2] These exhibits, while not printed in the appendices below, were made a part of the record on review by appropriate order of the court below. (R.A. 36-38.)

tions are taxable on the incomes which they earned, and that they could not escape their tax liabilities even though they were wholly owned subsidiaries of a parent corporation and even though there was an anticipatory arrangement whereby they undertook to pay over the most considerable portion of their earnings to the parent company. In so deciding, the court below properly followed legal principles which have been too firmly established by this Court to admit of any serious dispute.

Possessing inherent control over their corporate assets and profits, and having utilized those assets in combination with the services of their employees to create income, these taxpayers are the economic earners of that income. Because corporations have been selected by Congress as taxable entities they, and not their stockholders, are taxable in the first instance on the business income earned by the corporation. *Moline Properties* v. *Commissioner*, 319 U. S. 436; *United States* v. *Joliet & Chicago R. Co.*, 315 U. S. 44; *Burnet* v. *Commonwealth Imp. Co.*, 287 U. S. 415. See *Higgins* v. *Smith*, 308 U. S. 473, 477-478; *New Colonial Co.* v. *Helvering*, 292 U. S. 435, 442; *Edwards* v. *Chile Copper Co.*, 270 U. S. 452, 456. The earnings of the corporation may normally not be regarded as those of its stockholder even where, as here, a single stockholder owns all of the stock and is able to dominate and control the corporation. *Moline Properties* v. *Commissioner*, *supra*; *Burnet* v. *Commonwealth Imp. Co.*, *supra*. Nor may the corporation avoid

being taxed on its income by channeling its earnings directly to its stockholders, for its basic rule that income is taxable to the persons who earns it is as applicable when the taxpayer is a corporation as it is where he is an individual. *United States* v. *Joliet & Chicago R. Co., supra.* The decisions holding various arrangements ineffectual whereby the earner of income attempts to deflect it to another are firmly rooted (*Commissioner* v. *Sunnen*, 333 U. S. 591, and cases cited; *United States* v. *Joliet & Chicago R. Co., supra*) and conclusively demonstrate that, even though the taxpayer corporations here were under agreement to pay all except a minute portion of their earnings to the parent company, this would not suffice to constitute the parent as the taxable owner of the income.

While the taxpayers (Pet. 10-14) assert that the income is taxable solely to the parent because it belonged to it, as principal, and that the taxpayers were acting as corporate agents, there is nothing in the record to substantiate this claim. On the contrary, the uncontradicted facts stand in complete refutation. Even under local law concepts respecting the principal-agent relationship, it seems plain that none was created here. A common law agent must possess power to "bind" a principal, *i.e.*, to alter legal relationships between the principal and third persons. See Restatement of the Law of Agency, Section 12. The subsidiaries here by agreeing to use their own manufacturing plant, and

to utilize their own services, in order to create their own products, which were sold to the public as their own, were not granted any authority to alter legal relationships between the parent corporation and anyone else. Consequently, no principal-agent relationship was created even though the subsidiaries, as self-styled agents, agreed to relinquish the most substantial part of their profits to the parent. However, regardless of how local law would classify such a contract, it is manifest that the economic earner of the income cannot place himself beyond the reach of the taxing statute by agreeing that another shall be the "owner" of the income which is produced by his own property and services, and by denominating the parties as "agent" and "principal." The taxing statute is not concerned with the words or forms by which the parties may choose to label a situation. Cf. *Griffiths* v. *Commissioner*, 308 U. S. 355; *Higgins* v. *Smith*, 308 U. S. 473; *United States* v. *Joliet & Chicago R. Co.*, 315 U. S. 44. Absent a true principal and agent relationship, calling the corporation an agent of the stockholder is only another manner of contending that the corporate entity should be disregarded. *Moline Properties* v. *Commissioner*, 319 U. S. 436, 440-441.

The court below, accordingly, was altogether correct in ruling that the corporate identities of the taxpayers were not to be disregarded, and in holding that they were taxable on their earnings unaffected by the circumstance that, after being

earned, those profits were routed to the parent stockholder by a contractual device rather than through the normal declaration of dividends. The Tax Court's ruling to the contrary was erroneous as a matter of law, and was properly reversed by the Circuit Court of Appeals.

2. There is no conflict in decisions. *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330, which the Tax Court thought required the subsidiaries' earnings to be taxed to the parent (R. A. 29-32), and which the taxpayers now rely on as supporting their "agency" argument and as creating a conflict in decisions (Pet. 10-14), has no bearing on this case. Except for the circumstance that both cases have a parent corporation and a wholly owned subsidiary in the picture, they possess nothing in common respecting their factual situations, the issues presented for decision, or the principles to be applied.

In *Southern Pacific Co.* v. *Lowe*, *supra*, the subsidiary owned certain railroad property which it leased to the parent which used it in operating its railway system. The principal source of the subsidiary's income was derived from the rental payments made by the parent company. The subsidiary had a large book surplus on January 1, 1913, largely in the form of a debit against the parent, and in 1914, it paid certain dividends to the parent, the payments being effectuated largely by bookkeeping entries. The issue in the case was whether the parent was taxable on the portion of the divi-

dends derived from the subsidiary's pre-1913 earnings. In holding that the parent was not taxable, the Court ruled that the relationship between the corporations had been such that the income had (p. 337) "in truth and in substance" accrued to the parent before 1913 and that Congress had not intended to tax such income.

The issue in the present case is whether a subsidiary, regardless of the affinity between it and its parent corporation, can escape being taxed on the income which it earns. *Southern Pacific* v. *Lowe, supra*, could not be in conflict with the decision below for no such question was there decided; on the contrary, it had been conceded, in effect, that the subsidiary there was taxable on its income since it had consistently paid the taxes on its earnings.[3] The only question in that case concerned the parent's taxability on dividends paid out of the pre-1913 earnings of the subsidiary; there was not even any issue respecting the parent's tax liability on the dividends paid out of the subsidiary's post-1913 earnings, since it had actually paid the tax on

[3] No. 452, October Term, 1917, R. 183-185, Plaintiff's Exhibit O, being a letter from the Commissioner of Internal Revenue to the subsidiary (Central Pacific Railway Company) recommending additional excise taxes on income for the years 1909-1912; R. 186-189, Plaintiff's Exhibit P, being the income tax returns of the subsidiary for the calendar year ended December 31, 1913, and for the six months ended June 30, 1914; R. 190-191, Plaintiff's Exhibit Q, showing changes made by the Internal Revenue Department in the subsidiary's return of annual income for the fiscal years ended June 30, 1910, to June 30, 1914; R. 192, Plaintiff's Exhibit R, showing income and profit and loss on which the subsidiary paid income taxes for the fiscal years ended June 30, 1910, to June 30, 1914.

such dividends.[4] It is thus clear that *Southern Pacific* v. *Lowe*, in passing on what had become income prior to March 1, 1913, decided nothing which is pertinent to this case or which is in conflict with the decision below. Indeed, the opinion there (pp. 338-339) noted that the case turned on its own peculiar facts, and this observation has been reiterated in other decisions which recognize that the case did not lay down any general rule for deciding tax controversies. *Lynch* v. *Hornby*, 247 U. S. 339, 346; *Burnet* v. *Commonwealth Imp. Co.*, 287 U. S. 415, 420; *Moline Properties* v. *Commissioner*, 319 U. S. 436, 439.

The Tax Court was mistaken in interpreting the *Southern Pacific* case as permitting the corporate entities of the taxpayers here to be disregarded and as requiring that their earnings be taxed to the parent company. The taxpayers are equally mistaken in attempting to support the Tax Court on grounds of an "agency relationship" (Pet. 10) for, as indicated, the *Southern Pacific* case decided nothing about the subsidiary's earnings being tax-

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[4] The opinion of the District Court, 238 Fed. 847, 848 (S.D. N.Y.), shows that the parent received dividends of $912,497.48 on January 13, 1914, and states that this "* * * represents only the portion of the dividend paid on January 13, 1914, which the plaintiff claims exceeded the net earnings of the company during the period." The dividends actually received on that date totalled $4,036,530, of which $3,124,032.52 were included in the parent's tax return, the balance of $912,497.48 being excluded because not paid out of post-1913 earnings. The parent also received a dividend on June 30, 1914, on preferred stock of $522,000, which amount was also included in its tax return. See No. 452, October Term, 1917, *supra*, R. 148, Plaintiff's Exhibit 2-H.

able to the parent. Although, in describing the relationship between the corporations in the *Southern Pacific* case, the Court did (p. 337) refer to the subsidiary as an "agent" of the parent, it plainly did not employ that term in a technical sense, and it certainly did not use that description in the same manner as the taxpayers do here, for there it was the parent which utilized the subsidiary's railroad property in conducting the business, while in the present case the subsidiaries are the corporations which not only own the property, but which are also actively engaged in conducting the business. Further, as already demonstrated, no genuine agency relationship between the parent and the subsidiaries exists in this case. *Southern Pacific* v. *Lowe*, accordingly, cannot be in conflict with the decision here, and the Circuit Court of Appeals correctly held that the case is not controlling.

There is nothing even in (Pet. 13) "the implications of the decision" in *Interstate Transit Lines* v. *Commissioner*, 319 U. S. 590, which conflicts with the decision here. In holding that the parent corporation in that case was not entitled to a deduction for payments made to reimburse its subsidiary corporation on account of its operating deficits, the Court, even if it should be understood as intimating that the deduction would have been allowed to the parent under other circumstances (See Pet. 12), did not imply that the subsidiary's earnings would be directly taxable to the parent. Finally, *Moline Properties* v. *Commissioner*, 319 U. S. 436

(Pet. 12), which decided that corporate gains are taxable to the corporation and not to its sole stockholder, far from being a direct or indirect source of conflict, is the latest expression of this Court which marks the correctness of the decision below. It demonstrates (pp. 440-441) that unless the corporation is truly acting as an agent with respect to the stockholder's property, the type of agency argument which the taxpayers here advance cannot avail to make the stockholder the taxable owner of the corporation's income. While in the *Moline* case the Court noted the absence of (p. 440) an "actual contract of agency", it would be difficult to assume that a different result would obtain merely because the parties speak in agency terms and reduce an agreement to writing, but do not actually created a true agency relationship.

3. Relying on *Dobson* v. *Commissioner*, 320 U. S. 489, rehearing denied, 321 U. S. 231, the taxpayers state (Pet. 14):

> The Circuit Court of Appeals exceeded its powers of review and so far departed from the accepted and usual course of judicial procedure in like cases as to call for the exercise of this Court's powers of supervision and correction.

This assertion is based on the assumption that the issue in the Tax Court was a simple factual question; namely, whether an agency relationship existed between the subsidiaries and the parent, and on the further assumption that the Tax Court did no more than to resolve this fact issue in

favor of the taxpayers. (Pet. 14-15.) We disagree.

No matter with what inflections its opinion be read, when considered in its entirety it can leave no doubt that the Tax Court decided that the relationship between the parties brought the taxpayers (R. A. 32) "* * * within the rule announced by the Supreme Court in *Southern Pac. Co.* v. *Lowe, supra*" and that that case required a deviation from the usual doctrine of not disregarding corporate entities (R. A. 29) "where the subsidiary is so much a part of the parent in its operations that it amounts to no more than a mere department or agency." The principles applied by the Tax Court were such that the correctness of its decision depended, not on its appraisal of the undisputed facts, but on its construction of the judicial decisions interpreting the intention of Congress in the taxation of corporations. This was the manner in which the Circuit Court of Appeals, too, considered the Tax Court's decision. (R. C. 8-9.) The issue thus raised was one on which the reviewing court was empowered to reverse if it had been erroneously decided by the Tax Court. *McWilliams* v. *Commissioner*, 331 U. S. 694; *Crane* v. *Commissioner*, 331 U. S. 1; *Commissioner* v. *Wilcox*, 327 U. S. 404; *Trust of Bingham* v. *Commissioner*, 325 U. S. 365.

Even if the Tax Court had actually decided the case as though no generalizing principle were involved, the Circuit Court of Appeals would still have been required to reverse. As we have pre-

viously shown, there is nothing in the record to support the conclusion that there was a principal-agent relationship which would suffice to make the parent the taxable owner of the income. Accordingly, any contrary conclusion drawn by the Tax Court would have lacked support in the record.

We also disagree with the taxpayer's contention that the scope of the reviewing court's authority in this case poses an important question because Section 1141(a) of the Internal Revenue Code was amended by Section 36 of the Act of June 25, 1948, Public Law 773, 80th Cong., 2d Sess., which, effective September 1, 1948, makes the decisions of the Tax Court subject to review by the Courts of Appeals "* * * in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury * * *." Since the court below was fully empowered to reverse under Section 1141(c) of the Internal Revenue Code, as interpreted by *Dobson* v. *Commissioner, supra,* it would plainly have no less authority under the new amendment which was intended to abrogate the so-called *Dobson* rule and which was not intended to narrow the functions of the reviewing court. The taxpayers, accordingly, are requesting an academic discussion by this Court on the precise authority of the Courts of Appeals under the amendment to Section 1141(a), when the problem has no bearing on this case.

4. There are no other reasons why the writs should be granted. In the *Moline Properties* case,

supra, certiorari had been granted to resolve the then existing conflict in decisions respecting the integrity of the corporate entity for tax purposes and the taxability of corporate income *vis a vis* stockholder and the corporation. The failure of the Tax Court to follow that decision in a particular case, even though all its members participate (Pet. 16-19), does not require this Court to pass upon the matter again, and to reiterate principles which have already been laid down for the guidance of the lower tribunals. The Circuit Court of Appeals was competent to reverse an erroneous decision where that guidance had been ignored. Further review by this court is not warranted.

CONCLUSION

There is no conflict in decisions. The case was correctly decided by the court below in accordance with the controlling decisions of this Court. The petition for writs of certiorari should be denied.

Respectfully submitted,

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AUGUST, 1948.

Revenue Act of 1938, c. 289, 52 Stat. 447:

SEC. 13. TAX ON CORPORATIONS IN GENERAL.

* * * * *

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation the net income of which is more than $25,000 * * *.

* * * * *

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *.

* * * * *

SEC. 45. ALLOCATION OF INCOME AND DEDUCTIONS.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is author-

ized to distribute, apportion, or allocate gross income or deductions between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

SEC. 602. EXCESS-PROFITS TAX.

(a) If any corporation is taxable under section 601 with respect to any year ending June 30, there is hereby imposed upon its net income for the income-tax taxable year ending after the close of such year, an excess-profits tax equal to the sum of the following:

6 per centum of such portion of its net income for such income-tax taxable year as is in excess of 10 per centum and not in excess of 15 per centum of the adjusted declared value;

12 per centum of such portion of its net income for such income-tax taxable year as is in excess of 15 per centum of the adjusted declared value.

* * * * *

T. D. 4829, 1938-2 Cum. Bull. 98:

EXCESS-PROFITS TAX

Regulations Relating to the Excess-Profits Tax Imposed by Section 602 of the Revenue Act of 1938

* * * * *

ART. 2. *Scope of tax.*—The excess-profits tax, imposed by section 602 of the Revenue

Act of 1938, is imposed upon the net income of every corporation for each income-tax taxable year ending after the close of any year ending June 30 in respect of which the corporation is subject to the capital stock tax imposed by section 601 of that Act.

Treasury Regulations 101, promulgated under the Revenue Act of 1938:

ART. 13–1. *Tax on corporations in general.*—Section 13 imposes an income tax on corporations in general the net income of which is more than $25,000.

* * * * *

ART. 22 (a)–1. *What included in gross income.*—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. (See sections 22 (b) and 116). In general, income is the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets.

* * *

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